

# Residual Cash Earnings (RCE)

There are many business attributes that lead to high total shareholder return (TSR). When it comes to performance measurement, executives are often tempted to layer measures on measures. But this introduces **unnecessary complexity**, and worse, creates **adverse incentives**. So how can management teams effectively balance performance drivers to maximize long-term TSR?

Economic profit, whose most well-known iteration is Economic Value Added (EVA), was developed to serve as a comprehensive performance measure.

Fortuna's partners spent many years implementing Stern Stewart's EVA and applying Credit Su-

isse HOLT's cash flow return on investment (CFROI). In different ways, these two frameworks aimed to combine growth, profitability, and capital productivity to relate performance to valuation and share price performance.

Unfortunately, both of these measures are fairly complex, and EVA also has been found to discourage long-term growth investment. To arrive at a simpler measure that better balances growth and return, Fortuna conducted extensive capital market research to create Residual Cash Earnings (RCE).

More than any other performance measure, RCE provides a reliable value signal. To put it simply: up is good, down is bad, as shown in *Figure 2*. And most important, it shows a stronger relationship to TSR than EVA, or generic economic profit (see "*Beyond EVA*").

As shown in *Figure 1*, RCE consists of Gross Cash Earnings, which is EBITDA less tax costs plus P&L investments like R&D, less a capital charge based on Gross Operating Assets multiplied by a required return on capital. We use gross assets in the asset base for consistency with not charging for accounting depreciation.

*Figure 3* demonstrates the versatility of RCE in predicting shareholder returns across industries. While traditional economic profit has been criticized as applying only to "old world" companies with tangible assets, RCE is adjusted to capture intangible assets as well, as shown by industries like Software and Pharmaceuticals. To learn more about RCE and how it relates to your companies shareholder performance, reach out to [info@fortuna-advisors.com](mailto:info@fortuna-advisors.com).

FIGURE 1  
RCE Calculation



FIGURE 2  
Improvement in RCE Relates to Higher TSR

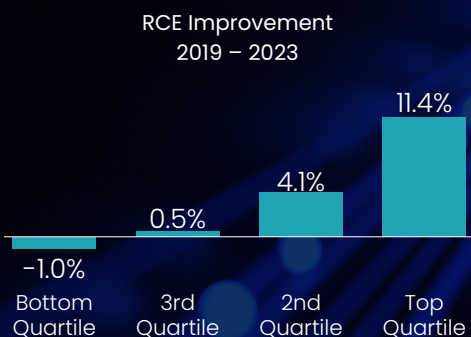


FIGURE 3  
Improvement in RCE Relates to Higher TSR

